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In the Supreme Court

OF THE

United States

OCTOBER TERM, 1983

THE FIRESTONE TIRE & RUBBER COMPANY,
Appellant,

VS.

FRANCHISE TAX BOARD,
Appellee.

On Appeal from the Court of Appeal of the State of California for the Second Appellate District

JURISDICTIONAL STATEMENT

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QUESTIONS PRESENTED

1. Whether the Due Process and Commerce Clauses of the Federal Constitution are violated by a state formulary apportionment method which, in the context of a worldwide combined report, (a) produces a distortion of income more than four times as great as that found to be permissible in *Container Corporation of America v. Franchise Tax Board*, and (b) includes income of foreign subsidiaries in the apportionable tax base of a United States parent corporation without appropriate adjustments to the property factor of the apportionment formula on account of the property of the foreign subsidiaries which produced such income and to the payroll factor of the formula on account of gross disparities in wage rates between the United States and the foreign countries in which the subsidiaries did business.

2. Whether a state appellate court applied an incorrect standard of review in reversing the decision of a state trial court that thirteen of appellant's foreign subsidiaries were not part of a unitary business, in so far as the reviewing court substituted its own independent judgment instead of determining whether the decision of the trial court, upon contraverted evidence, was "within the realm of permissible judgment."

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THE FIRESTONE TIRE & RUBBER COMPANY,
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vs.
FRANCHISE TAX BOARD,
Appellee.

On Appeal from the Court of Appeal of the State of California for the Second Appellate District

JURISDICTIONAL STATEMENT

Appellant, The Firestone Tire & Rubber Company (hereinafter called sometimes "Firestone"), appeals from the judgment of the Court of Appeal of the State of California, Second Appellate District, upholding the right of the Franchise Tax Board of the State of California to determine the taxable income of appellant and its twenty-two majority-owned foreign subsidiaries on the basis of a worldwide combined report, without any adjustment to the property factor of the apportionment formula on account of the major income-producing asset of its Liberian subsidiary (a long-term leasehold covering a one million acre rubber plantation) or to the payroll factor on account of proved wage differentials, and where the resulting distortion of income produced by the unadjusted formula more than quadruples

that which was held to be acceptable in *Container Corporation of America v. Franchise Tax Board*, ___ U.S. ___, 77 L.Ed2d 545, 103 S.Ct. ___ (1983), rehearing denied ___ U.S. ___, 78 L.Ed2d 248, ___ S.Ct. ___ (1983).

In reaching its judgment, which reversed in part the decision of the state trial court that thirteen of appellant's twenty-two foreign subsidiaries were *not* engaged in a unitary business with appellant during the relevant years at issue, the Court of Appeal, moreover, applied an incorrect standard of appellate review by making an independent review of the evidence instead of determining, as called for by *Container*, whether the decision of the trial court was "within the realm of permissible judgment."

Pursuant to Supreme Court Rule 28.1 a list of appellant's twenty-two majority-owned foreign subsidiaries relevant to this appeal is set forth in Appendix "A".

OPINIONS BELOW

A copy of the Opinion and Judgment of the Court of Appeal, dated January 20, 1984, from which this appeal is taken, is reproduced at Appendix "B". A copy of the Order of the Court of Appeal Denying Rehearing and Modifying Opinion, dated February 9, 1984, is reproduced at Appendix "C". Neither the Judgment nor the Order on Rehearing were published in either the official or the unofficial reports of California.

A copy of the Order of the California Supreme Court Denying Hearing, dated May 2, 1984, is reproduced at Appendix "D". Said Order was likewise not published in the California Reports.

A copy of the Findings of Fact and Conclusions of Law of the state trial court, dated April 22, 1980, is reproduced at Appendix "E". A copy of the Judgment of said court, also dated April 22, 1980, is reproduced at Appendix "F". Neither of said documents was published.

A copy of appellant's Notice of Appeal to the State Court of Appeal from the Judgment of the state trial court, filed May 23, 1980, is reproduced at Appendix "G".

A copy of appellant's Notice of Appeal to this Court from the Judgment of the State Court of Appeal, which said notice was filed on May 8, 1984 in the California Court of Appeal, Second Appellate District, is reproduced at Appendix "H".

JURISDICTION

The Court of Appeal rendered its opinion and judgment on January 20, 1984, affirming in part and reversing in part the California trial court's judgment. Appellant's petition for rehearing was filed February 3, 1984 and was denied by the Court of Appeal on February 9, 1984 (Appendix "C"). Appellant's petition for hearing in the California Supreme Court was filed March 12, 1984 and was denied May 2, 1984 (Appendix "D").

A notice of appeal was filed in the Court of Appeal on May 8, 1984 (Appendix "H"). The time within which to docket the appeal in this Court expires on July 31, 1984, and timely docketing has been made. The jurisdiction of this Court is invoked under 28 *U.S.C.* § 1257(2).

CONSTITUTIONAL, STATUTORY AND REGULATORY PROVISIONS

During the income years at issue (ending 10/31/60 through 10/31/63, inclusive) Section 25101 of the *California Revenue and Taxation Code* provided, in so far as pertinent to this appeal, as follows:

> "When the income of a taxpayer subject to the tax imposed under this part is derived from or attributable to sources both within and without the State, the tax shall be measured by the net income derived from or attributable to sources within this State. Such income shall be determined by an allocation upon the basis of

sales, purchases, expenses of manufacture, pay roll, value and situs of tangible property or by reference to any of these or other factors or by such other method of allocation as is fairly calculated to determine the net income derived from or attributable to sources with this State; . . . ." [1957 *Calif. Stats.*, Ch. 2097, §1]

The relevant portions of the pertinent California regulation, 18 *California Administrative Code*, Reg. §25101(a), is reproduced at Appendix "I".

The relevant portions of the United States Constitution are the Due Process Clause of the Fourteenth Amendment and the Commerce Clause, including both its Interstate and Foreign Clauses, as follows:

". . . nor shall any State deprive any person of . . . property . . . without due process of law; . . ." [*U.S.C.A.* Const. Amend. XIV, Sec. 1].

"The Congress shall have Power . . . to regulate Commerce with foreign Nations, and among the several States . . ." [*U.S.C.A.* Const. Art. 1 §8 cl. 3]

STATEMENT

During the income years at issue (1960 through 1963) the State of California imposed a franchise tax on the net income of corporate taxpayers doing business within its jurisdiction. *Calif. Rev. & Tax Code* §25101. If a taxpayer was doing business both within and without the state, California typically used a three-factor apportionment formula, consisting of property, payroll, and sales, by which to determine that portion of the taxpayer's total income which derived from or was attributable to sources within the state. If two or more corporations linked by common ownership were engaged in a single "unitary business" the California franchise tax liability of the enterprise was computed on the basis of a "combined" report. *Edison California Stores, Inc. v. McColgan*, 30 Cal. 2d 472, 183 P. 2d 16 (1947).

In *Container Corp. v. Franchise Tax Board, supra*, this Court, in a matter of first impression, upheld the right of the State of California, under its Bank and Corporation Tax Law, to assess a domestic United States parent corporation engaged in a single unitary business with foreign (i.e., non-U.S.) subsidiaries on the basis of a worldwide combined report, wherein the incomes of the parent-company taxpayer and its majority-owned foreign subsidiaries are first aggregated and then apportioned by formula. In so doing, the Court rejected the argument that the worldwide combination method was unconstitutional *per se* under the Foreign Commerce Clause of the Federal Constitution. In addition, the Court held that, based upon the facts before it in the *Container* case, in which there was a displacement of income of approximately 14%, no Due Process standards were violated.

The present case goes beyond *Container* in at least two respects and presents the Court with an opportunity to further its case law in the unitary business area. First, the amount of distortion proved in the present record is approximately four times as great as that which was held to be within the parameters of the Due Process Clause in *Container*. Second, and more dramatically, this case focuses upon the issue as to whether there can in fact be any true apportionment at all where factor relief does not accompany the inclusion of income in the apportionable tax base. Also at issue is whether the state court from whose judgment this appeal has taken erred in its failure to apply the standard of appellate review announced by this Court in *Container*.

Container, of course, forecloses the argument, as advanced by petitioner in the state court, that the worldwide combined reporting method of taxation is unconstitutional *per se*. Beyond and in addition thereto, however, appellant contends, and indeed has contended at each state court level

throughout the proceeding at issue, that the California statute and its implementing regulation, as applied to appellant in the context of a worldwide combined report, results in a distortion of income of such magnitude as to contravene the requirements of both the Due Process and Commerce Clauses of the Federal Constitution.

The Firestone Tire & Rubber Company (herein variously referred to as "appellant" or "Firestone") was and is engaged in the manufacture, distribution and sale throughout the United States, of tires, tubes, and related products. Appellant, an Ohio corporation, was actively doing business in the State of California throughout the period in issue and was therefore subject to filing a California franchise tax return under the California Bank and Corporation Tax Iaw, *Calif. Rev. & Tax. Code* §§23001 *et seq.*

In addition to its tire and rubber operations, appellant owned a majority interest in various domestic and foreign subsidiaries. Of these, twenty-two foreign subsidiaries (*i.e.*, subsidiaries incorporated and doing business wholly outside the United States) and one domestic subsidiary (Ravenna Arsenal, Inc.) are relevant to this appeal. A list of the subsidiaries by name is found in Appendix "A".

Following an audit of appellant's California franchise returns for the years in issue, respondent assessed additional tax as follows:

Income Year	Amount
1960	$180,588.86
1961	154,800.12
1962	120,581.33
1963	118,817.41
Aggregate amount of deficiency assessments of issue	$574,787.72

The additional tax resulted from the demand by respondent that appellant file its California returns on the

basis of a "worldwide combined report", wherein the pre-tax or "taxable" incomes of appellant and all of its majority-owned foreign and domestic subsidiaries were first aggregated and then "apportioned" to California by means of a three-factor formula.

Appellant, under protest, duly paid the additional assessments, together with interest, and thereafter filed claims for refund, upon denial of which this action commenced.

Of appellant's twenty-two foreign subsidiaries, fourteen engaged in the manufacture and sale of tires, tubes, and related products; four were primarily sales companies; one operated natural rubber plantations in Liberia [R.T. 752:2-9]; two were involved in brokerage activities relating to the purchase and sale of natural rubber [R.T. 1461:22-25]; and one ran a "general store" type of operation in Liberia [R.T. 719:16-720:2].

Each of the foreign subsidiaries was incorporated and did business wholly abroad [C.T. 1668:3 *et seq.*]. None of them did business in the State of California or in any other state of the United States during the years at issue. [R.T. 724: 1-5]. None of them had a permanent business establishment, sales office, employees, or any real or tangible personal property in California or in any other state in the United States during the years at issue, nor did any of them make any sales or incur any payroll expense in California or in any other state of the United States during the years at issue [R.T. 766:10-12].

The Plantations Company operated natural rubber plantations at Harbel, Liberia and at Cavalla, Liberia [R.T. 846:21-847:10], which were acquired from the Liberian Government in or about 1926, under a ninety-nine year lease arrangement at a nominal per annum rental cost [Exhibit 534, C.T. 2531-2553; R.T. 1011:10-26]. Appellant made various improvements in the form of roads, sewer and com-

munications systems and railways on properties surrounding the acreage leased [Exhibit 534, Art. II(d); C.T. 2537]. In addition, costs were incurred in connection with the clearing, cultivation, planting and maintenance of the one hundred thousand acres which were actively in production during the years at issue [R.T. 1021:13-26]. Nevertheless, as of the beginning and through the period in issue, the "depreciated net book value" of the leasehold, a major income-producing asset of Plantations Company, was essentially zero[1] [R.T. 1013:21-1014:14].

The natural rubber plantation at Harbel, Liberia was approximately one million acres in size, of which approximately one hundred thousand acres were in active production during the years at issue. The remaining nine hundred thousand acres were being held in reserve and in a state of availability for future production [R.T. 1018:8-19]. At Cavalla, approximately eighteen thousand acres were under cultivation [R.T. 847:2-10].

The trial court found thirteen of the foreign companies *not* to be unitary with appellant and the remaining nine to be unitary [cf. App. "E", p. 32]. The trial court also held that no adjustments were required to be made to the apportionment formula as applied to appellant. As noted, the Court of Appeal, whose judgment is under review here, reversed the decision of the trial court with respect to the thirteen foreign subsidiaries found not to be unitary, and affirmed it in all other respects.

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[1]The property factor during the period in issue was computed on the basis of "depreciated net book value." [R.T. 645:8-21] The standard of "depreciated net book value" was changed to "original cost", per *Calif. Rev. and Tax. Code* §25120 *et seq.* effective January 1, 1967, but of the period at issue here.

THE QUESTION PRESENTED IS SUBSTANTIAL

This Appeal Involves Issues of First Impression With Regard to the Question of Factor Relief Where an Income Base is Subject to a State Income Tax Apportionment Formula and With Regard to the Parameters of Distortion Constitutionally Permissible When a State Apportionment Formula Has Been Applied to a Multinational Taxpayer

As was likewise true in *Container Corp. v. Franchise Tax Board*, — U.S. —, 77 L.Ed 2d 545, 103 S.Ct. — (1983), this appeal involves a matter of first impression to the extent it addresses the issue of factor relief, where the formulary apportionment method of state income taxation is concerned. This issue was alluded to but not decided in *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 63 L.Ed 2d 510, 100 S.Ct. 1223 (1980), for the reason that the question of factor relief had not been preserved on the record, not having been raised at the administrative level. 63 L.Ed 2d, at p. 523, fn. 15.

Nor was the question of factor relief reached in *Asarco, Inc. v. Idaho State Tax Comm'n.*, 458 U.S. —, 73 L.Ed 2d 787, 102 S.Ct. 3103 (1982), or in *F. W. Woolworth Co. v. Tax. & Rev. Department*, 458 U.S. —, 73 L.Ed 2d 819, 102 S.Ct. 3128 (1982), because the issue was mooted by the holdings therein that neither taxpayer was engaged in a unitary business.

Finally, *Container*, in which worldwide combined reporting was upheld, had neither the magnitude of distortion present in the instant appeal nor any issue relating to exclusion of a major income-producing asset from the apportionment factors.

Although this Court in *Container* affirmed the constitutionality of worldwide combined reporting, the Court by no means foreclosed the right of a taxpayer to assert, upon an appropriate factual showing, that formula apportionment

in the context of a worldwide combined report has resulted in distortions of such magnitude as to contravene the requirements of the Due Process and Commerce Clauses of the Federal Constitution.

This case presents the Court with an opportunity to define the parameters of the amount of distortion permissible under the Due Process and Commerce Clauses as well as the opportunity to address the factor relief, if any, which is required on account of income which has been included in the apportionable tax base.

I.

THE DISTORTION IN THE PRESENT CASE IS SO SEVERE AS TO REPRESENT EXTRATERRITORIAL TAXATION AND SO AS TO VIOLATE THE PRINCIPLE OF FAIR APPORTIONMENT

A. Both the Due Process and Commerce Clauses Prohibit a State Income Tax Formulary Method From Resulting in an Unreasonable Distortion of Income

It is a fundamental principle of constitutional law that a state may not, when imposing an income-based tax, reach income earned beyond its borders. *Asarco Inc. v. Idaho State Tax Comm'n., supra; Moorman Mfg. Co. v. Bair,* 437 U.S. 267-272-273, 57 L.Ed 2d 197, 98 S.Ct. 2340 (1978); *National Bellas Hess Inc. v. Illinois,* 386 U.S. 753, 756, 18 L.Ed 2d 505, 87 S.Ct. 1389 (1967); *Norfolk & Western R. Co. v. Missouri State Tax Comm'n.,* 390 U.S. 317-325, 19 L.Ed 2d 1201, 88 S.Ct. 995 (1968). This principle applies under both the Due Process and Commerce Clauses of the Constitution. *Container Corp. v. Franchise Tax Board,* 77 L.Ed 2d, at p. 552. Nor may a state tax tangible or intangible property that is unconnected with the state. *Norfolk & Western R. Co. v. Missouri State Tax Comm'n.,* 390 U.S., at p. 324; *Fargo v. Hart,* 193 U.S. 490, 499, 48 L.Ed 761, 765, 24 S.Ct. 498 (1904). In *Norfolk & Western R. Co. v. Missouri State Tax Comm'n.,* this Court held:

> "The taxation of property not located in the taxing state is constitutionally invalid, both because it imposes an illegitimate restraint on interstate commerce and because it denies to the taxpayer the process that is its due. A state will not be permitted, under the shelter of an imprecise allocation formula or by ignoring the peculiarities of a given enterprise, to 'project the taxing power of the state plainly beyond its borders.' " 390 U.S., at p. 325.

Second, there must be a "rational relationship" between income attributed to a state and the intrastate values of the business enterprise. *F. W. Woolworth Co. v. Tax. & Rev. Dept.*, 73 L.Ed 2d, at p. 827; *Mobil Oil Corp. v. Vermont*, 63 L.Ed 2d, at p. 520; *Moorman Mfg. Co. v. Bair*, 437 U.S., at pp. 272, 273; *National Bellas Hess Inc. v. Illinois*, 386 U.S., at page 756; *Norfolk & Western R. Co. v. Missouri State Tax Comm'n.*, 390 U.S., at page 317. A tax cannot be "out of all appropriate proportion" to the business done in the taxing jurisdiction. *Exxon Corporation v. Wisconsin Department of Revenue*, 447 U.S. 207, 65 L.Ed 2d 66, 79, 100 S.Ct. 2109 (1980); *Hans Rees' Sons, Inc. v. North Carolina*, 283 U.S., at p. 135.

Third, the taxpayer has the "distinct burden of showing by clear and cogent evidence that the state tax results in extraterritorial values being taxed." *Container Corp. v. Franchise Tax Board*, 77 L.Ed 2d at p. 552. If, however, a taxpayer proves by such evidence that the income attributed to a state by an apportionment formula is "out of all appropriate proportion to the business transacted" in that state, the assessment cannot stand. *Moorman Mfg. Co. v. Bair*, 437 U.S., at p. 274. In the *Container* case this Court held:

> "The Constitution does not 'invalidat[e] an apportionment formula whenever it may result in taxation of some income that did not have its source in the taxing State.' (citations omitted) Nevertheless, we will strike

> down the application of an apportionment formula if the taxpayer can prove 'by "clear and cogent evidence" that the income attributed to the State is in fact "out of all appropriate proportions to the business transacted in that State," (citation omitted), or has "led to a grossly distorted result," (citation omitted)' " 77 L.Ed 2d, at p. 556.

Not all state income tax apportionment formulas are constitutionally sacrosanct in their application. This Court has held:

> "When the state has adopted a method not intrinsically arbitrary, it will be sustained until proof is offered of an unreasonable and arbitrary application in particular cases."
>
> *Hans Rees' Sons, Inc. v. North Carolina,* 283 U.S. 123, 133, 75 L.Ed 879, 51 S.Ct. 385 (1931).

B. Appellant Has Sustained Its Burden of Proof That the Formula Is Distortive

The record in this appeal demonstrates that appellant's income attributable to California by reason of worldwide formulary apportionment was "out of all appropriate proportion" to the business conducted by appellant in the state. *Butler Brothers v. McColgan,* 315 U.S., 501, 507, 86 L.Ed 991, 62 S.Ct. 701 (1942); *Hans Rees' Sons, Inc. v. North Carolina,* 283 U.S., at p. 135. This is precisely the showing which the taxpayer in *Mobil* failed to make to substantiate its argument therein that the inclusion by the State of Vermont of "foreign source" dividend income in the tax base contravened the Due Process Clause of the Fourteenth Amendment. *Mobil Oil Corporation v. Vermont, supra,* 63 L.Ed 2d, at p. 521.

C. Where Factor Relief Does Not Accompany the Inclusion of Income in an Apportionable Tax Base, an Unreasonable Distortion of Income Results

The most glaring aspect of the distortion issue in the present appeal has to do with the Liberian leasehold of appellant's subsidiary, Firestone Plantations Company, which was totally unrepresented in the property factor of the apportionment formula. Notwithstanding this significant omission, more than fifteen million dollars in average annual income of Plantations Company was included in appellant's apportionable tax base for California franchise tax purposes. This income, in turn, represented approximately thirteen percent of appellant's total combined apportionable tax base for California tax purposes during the years at issue.

The amount of income included in appellant's tax base on account of Plantations Company for the years at issue was as follows:

TABLE I

Income of Plantations Company Included
In Appellant's Tax Base

Income Year Ending	Firestone Plantations Company
10/31/60	$24,152,542
10/31/61	13,498,000
10/31/62	13,069,000
10/31/63	11,659,000
Avg.	$15,594,636

Source: Exs. 685Q, 686Q, 687Q, 688Q

In turn, the portion of appellant's tax base represented by Plantations Company income during the period in issue is shown as follows:

TABLE II

Income Year Ending	Taxable Income of Plantations Co.	Appellant's Revised Combined Income Per Assessments	%
10/31/60	$24,152,542	$113,528.671	21.3
10/31/61	13,498,000	121,514,288	11.1
10/31/62	13,069,000	118,485,693	11.0
10/31/63	11,659,000	125,533,580	9.3
Average 4-year percentage:			13.0%

Source: Exs. 382, 685Q, 686Q, 687Q, 688Q

Apparently, respondent based its failure to make an adjustment to the property factor for the Liberian leasehold on both its long-standing administrative practice by which it computed the property factor on the basis of depreciated net book value [R.T. 645:8 - 21; i.e., "California tax basis" per 18 *Cal. Adm. Code* §25101(a)], coupled with the fact that the Liberian leasehold had no depreciated net book value on the books of the Liberian subsidiary,[2] and on the applicable regulation which excluded leased property generally from the apportionment formula during the years in issue.[3] Neither rationale passes Constitutional muster. In effect, the primary income-producing asset of the Liberian subsidiary has been excluded completely from the formula.[4]

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[2]According to the testimony the acquisition and improvement costs relating to the Liberian rubber plantations had either been expensed currently or were already fully amortized by the period in issue [R.T. 1013:21-1014:14; 1650: 21 - 25.]

[3]cf. 18 *Cal. Adm. Code*, Reg §25101(a), set forth at Appendix "I".

[4]Even under California law, there were well-grounded exceptions to the administrative regulation which would limit the property factor to *owned* property during the period in issue. For example

For it is undisputed that the income of Plantations Company derived wholly from the sale of rubber produced on the Liberian rubber plantations [R.T. 1018:20-26; 1020: 2-9.]

It is axiomatic that in the apportionment of a unitary business the formula used must give adequate weight to the essential elements responsible for the earning of the income. *John Deere Plow Co.* v *Franchise Tax Board*, 38 Cal. 2d 214, 224-225, 238 P. 2d 569 (1951), appeal dism. 343 U.S. 939, 96 L.Ed 1345, 72 S.Ct. 1036 (1952). Indeed, it is widely acknowledged that property, payroll, and sales, which traditionally comprise the standard three-factor formula, are usually the factors most responsible for the earning of income. Altman and Keesling, *Allocation of Income in State Taxation* (2d Ed. 1950), at p. 97. This Court itself has characterized the three-factor formula as constituting

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in *McDonnell Douglas Corp. v. Franchise Tax Board*, 69 Cal. 2d 506, 72 Cal. Rptr. 465 (1968), the California Supreme Court held Reg. §25101(a) inapplicable to an aircraft manufacturer which, during years 1942 through 1945, had been given the use of various government-furnished manufacturing facilities. Even though the government-furnished plants had no net book value on the taxpayer's records, since the taxpayer did not own them, the Franchise Tax Board was not allowed to exclude the plants from the property factor of the apportionment formula, since they were instrumental to the production of the taxpayer's taxable income. In so doing, the Court noted that the statute applicable with respect to income years beginning on or after January 1, 1967 had been amended to include rented property in the formula. cf. *Calif. Rev. & Tax Code* §25129.

cf. also *Chase Brass & Copper Co. v. Franchise Tax Board*, 70 Cal. App. 3d 457, 138 Cal. Rptr. 901 (1977), appeal dism. 434 U.S. 1029, 54 L.Ed 2d 777, 98 S.Ct. 759 (1978), rhng. den. 435 U.S. 910, 55 L.Ed 2d 501, 98 S.Ct. 1461 (1978), wherein the California Court of Appeal held that the use of "original cost" with respect to mining properties acquired by the taxpayer was both a logical and reasonable approach to valuation for purposes of the property factor, even with respect to income years in which Reg. §25101(a) was purportedly applicable.

a "rough practical approximation" of the distribution of either a corporation's sources of income or the social costs which it generates. *General Motors Corp.* v *District of Columbia*, 380 U.S. 553, 561, 14 L.Ed 2d 68, 85 S.Ct. 1156 (1965).

Formulary apportionment is simply one of several well recognized means (two others, for example, being specific allocation and separate accounting) of "dividing up" a tax base. Boren, "Equitable Apportionment: Administrative Discretion and Uniformity in the Division of Corporate Income for State Tax Purposes", 49 *So. Cal. Law Rev.* 991, 994 (1976). If, of course, an apportionment formula applied with theoretical precision, it would be "logically impossible . . . to have the same income taxed twice" since the tax would then be fairly apportioned. *Northwestern States Portland Cement Company* v *Minnesota*, 358 U.S. 450, 462, 3 L.Ed 2d 421, 79 S.Ct. 357 (1959). cf. Madere, "State Taxation after Mobil and Exxon", *Tax Executive* (Jan. 1981) p. 106. An apportionment formula can approach the ideal of fair apportionment, however, only if and to the degree it gives "reasonable weight both to the in-state and out-of-state factors producing the income." Rudolph, "State Taxation of Interstate Business: The Unitary Business Concept and Affiliated Corporate Groups", 25 *Tax Law Review*, p. 171 (1970).

For the worldwide formulary apportionment method as applied to appellant in this case to approach even the "rough approximation" considered acceptable in the distribution of income among several taxing jurisdictions, cf. *International Harvester Co.* v *Evatt*, 329 U.S. 416, 422, 91 L.Ed 390, 67 S.Ct. 444 (1947), appropriate adjustments must be made to the factors of the formula, corresponding to income which has been included in the tax base. *Mobil Oil Corp. v. Vermont*, 63 L.Ed 2d, at p. 535, fn.16 (dissenting opinion of Stevens, J.); Rudolph, *supra*, at p. 205.

Stated another way, how, one may ask, can a tax base be divided equitably (or at all) among several taxing jurisdictions unless there is something in the factors by which to make the division?

In the case of Plantations Company, since the leasehold is totally unrepresented in the property factor, the California formula is purposely skewed in favor of the taxing state and away from the foreign jurisdiction, and there can be no true apportionment.

Moreover, by including the full amount of Plantations Company's taxable income in appellant's tax base, without any adjustment to the formula on account of the property from which such income was derived, the California formula has resulted in a substantial distortion of income in favor of the taxing state. For example, in 1963 (the last of the four years at issue) the California formula produces an 82% distortion of income on account of Plantations Company, as shown in Table VI, *infra*. Obviously, this amount of distortion far exceeds that considered tolerable in *Container* and should bring Constitutional strictures into play.

Compounding the failure to represent the Liberian leasehold in the property factor, respondent's failure to adjust the payroll factor on account of proven wage differentials between the domestic and foreign taxing jurisdictions magnifies the distortion in favor of California.

During the period in issue, average hourly wages in California were twenty times as great as those in Liberia. Conversely, the average hourly wage rates which prevailed in Liberia during the period in issue were approximately five percent of those in California.[5]

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[5]The following table shows the percentage relationship between the average hourly wages in Liberia to average hourly wages in California during the years at issue:

Table III in footnote 5 reflects the amounts by which the denominators of the payroll factor have to be adjusted upward on account of the inclusion of Plantations Company income in the tax base; otherwise, the formula does not "fairly calculate" appellant's California taxable income. These adjustments are solely a result of hourly wage rate differentials between Liberia and California during the years at issue. In this respect the average hourly wage rate in Liberia ranged between 14.7 cents and 17.9 cents per hour [Ex. 914] compared to a range between $3.03 and $3.31 an hour in California [Ex. 913].[6]

TABLE III

Average Hourly Wages
Liberia vs. California

	1960	1961	1962	1963
Firestone Plantations Co. [Ex.-914]	.147	.151	.160	.179
CA[Ex.913]	3.03	3.12	3.22	3.31
RATIO FPCO/-CA	.0485	.0484	.0497 (Avg. 61/63)	.0541
FPCO Wages*	4,439,994	4,540,941	4,638,464	4,735,986
Factor	÷ .0485	÷ .0484	÷ .0497	÷ .0541
"California basis" Wages	91,546,268	93,821,095	93,329,256	87.541,331
	(4,439,994)	(4,540,941)	(4,638,464)	(4,735,986)
Net Difference	$87,106,274	$89,280,154	$88,690,792	$82,805,345

*Per Wages, Salaries, & Employee Benefit Schedules [Exs. 886, 887 & 888] (not including salaries or employee benefits; figures shown are limited to hourly wages only)

[6]The actual straight-time average hourly wage rate in California for the period in issue, as verified to appellant's Wages, Salaries, and Employee Benefits schedules in evidence [Exs. 886 - 888], ranged between a low of $3.72 per hour in 1961 to a high of $4.02 in 1963 [Ex. 915]. Respondent, however, can hardly complain of the use of the lower figures in Exhibit 913, for the use of the latter results in a lower ratio and consequently a smaller upward adjustment to the denominator of the payroll factor on account of the Liberian wage differential.

Table IV[7] reflects the net tax impact to appellant of the failure to make the payroll adjustments on account of the Liberian wage differential. This adjustment alone would

[7]TABLE NO. IV

Net Tax Reduction Resulting From Use of "California Basis" Wages of Firestone Plantations Company on Account of *Comparative Wage* Rate Differentials

	1960	1961	1962**	1963
Payroll Denominator [Per Ex. 719]	$288,14,984	$280,057,453	$314,019,392	$340,458,509
"California Basis Adjustment" [per Table III]	87,106,274	89,280,154	88,690,792	82,805,345
Revised Denominator	375,253,258	369,337,607	402,710,184	423,263,854
Payroll Numerator [Per Ex. 719]	27,614,651	23,144,328	25,144,379	27,854,585
Revised Payroll Factor	7.3589	6.2664	6.2438	6.5809
Property Factor [Ex. 719]	5.364	5.3160	4.9745	5.5147
Revised Total Sales Factor [Ex. 719]	4.5277	4.1116	3.7060	3.6428
Revised Total Factors	17.2506	15.6940	14.9243	15.7384
Revised Combined Factor	5.7502	5.2313	4.9748	5.2461
Apportionable Income [Ex. 382]	13,528,671	121,514,288	118,485,693	125,533,580
Revised California Income	6,528,126	6,356,777	5,894,426	6,585,617
Revised Tax at 5.5%	359,047	349,623	324,193	362,209
Tax Per NPAS [Ex. 382]*	405,353	394,188	362,538	392,270
Tax Differential (Reduction)	(46,306)	(44,565)	(38,345)	(30,061)
Percent of Tax Reduction	11.42%	11.31%	10.6%	7.66%

Net 4-yr reduction in tax	$ 159,277
Aggregate Deficiency per 4 years in issue	$ 574,788
Percentage. Reduction	27.7%

* Includes tax (including deficiency assessments) assessed against appellant *and* its California subsidiaries with whom it filed its return.

** The "California basis" adjustment for 1962 was computed by using as the "straight time" hourly wages of Firestone Plantations Company an average of its hourly wages for 1961 and 1963, in view of the fact that appellant's "Wages, Salaries and Employee Benefits" schedules for income year ending 10/31/62 were unavailable.

have reduced the net deficiencies imposed by $159,277, or more than 27% of the aggregate deficiencies imposed.

A similar adjustment to the payroll factor is warranted on behalf of the remaining foreign subsidiaries on account of wage differentials proven in the record which are offset, if at all, only in part by variations in productivity [R.T. 1192:16-28; 1199:24-27.]

D. Distortion in the Case of Appellant More Than Quadruples That Found Constitutionally Acceptable in the Container Case

In the present case, the California apportionment formula, as applied to appellant, produces a distortion of income in favor of the taxing state which more than quadruples that which was found acceptable in *Container Corp.* v. *Franchise Tax Board.* Specifically, in appellant's case there is an average distortion factor in excess of 56% over the four-year period in issue. Moreover, in one year (1960) there was more than a 77% distortion of income, as shown below in TABLE V.

TABLE V

Percentage Shift of Income and
Tax Liability to California,
As a Result of California Formulary Method

	1960	1961	1962	1963
Cal. income per return	$4,086,620	$4,356,760	$4,399,210	$4,971,873
Calif. apportioned income*	7,247,670	7,043,090	6,472,755	6,977,784
[per notices of proposed assessment, Ex. 382]				
% Increase	77%	62%	47%	40%
		Average 4-year percentage increase in appellant's California income as a result of formulary method: 56%		
Cal. Tax per return	$ 224,364	$ 239,622	$ 241,957	$ 273,453
Cal. Tax per assessment*	398,622	387,370	356,002	383,778
% Increase	77%	62%	47%	40%
		Average 4-year percentage increase in appellant's California tax liability as a result of formulary method: 56%		

*Parent Company only, *not* including six (6) Calif. subsidiaries (*errs* on side of State)

The distortion in the case of individual foreign subsidiaries is even more dramatic. This phenomenon is illustrated in Table VI in the case of six representative foreign companies for year 10/31/63:

TABLE VI

Name of Foreign Subsidiary	Income Per Books	Income Apportioned By Formula	Foreign Income Taxes Paid	Distortion in Favor of California
Argentina	$ 6,185,571	$ 2,014,960	$ 2,163,323	67.4%
Brazil	7,243,107	3,100,659	3,807,402	57.2%
India	4,871,654	2,403,466	4,826,716	50.7%
Liberia	11,659,575	2,022,720	3,716,863	82.7%
New Zealand	2,322,556	648,906	1,202,698	72.1%
South Africa	6,638,877	1,429,245	244,984	78.5%
	$38,921,340	$11,619,956	$15,961,986	

Source: Exhibit 815

In the case of all six foreign companies the formula assigns measurably less income than that actually reported by the respective company. In the case of Liberia, the formula attributes to that particular company only 17.3% of its pretax income as used by respondent in computing appellant's apportionable tax base. Viewing the six companies in the aggregate, the formula attributes to them only 29.9% of their combined pretax incomes as used by respondent in determining appellant's tax base.

Moreover, in the case of five of the six companies the formula attributes *less* income to the foreign companies than the income taxes paid by those companies on such income to the respective foreign countries.

Finally, in connection with the six companies alone the formula causes a displacement in favor of the State of California of some $27,300,000 in income, representing approximately 70% of their aggregate pretax incomes.

Distortion of this magnitude cries out for redress under established principles of Due Process.

The Court of Appeal, while conceding that some distortion had indeed been established, refused nevertheless to prohibit use of the formulary apportionment method, citing the decision in *Container* [cf. App., "B" p. 15]. Appellant submits that the Court of Appeal erred in failing to distinguish the present case from *Container* in so far as the magnitude of proved distortion was concerned.

In *Container*, this Court noted that a displacement of income of approximately 14% did not represent distortion of a magnitude sufficient to invoke the Due Process Clause. 77 L.Ed.2d, at p. 565. On the other hand, the Court recognized that distortion of 250%, as was the case in *Hans Rees' Sons, Inc.* v. *North Carolina, supra*, did indeed violate the requirements of Due Process. There is indeed therefore a point beyond which distortion will be constitutionally intolerable. In the present record, appellant believes that that point has been reached.

The key concept is one of fairness. "Fairness" in the apportionment of income is not only a requirement of the relevant California statutory law, it is mandated by the Due Process Clause of the United States Constitution. As this Court has held:

> ". . . an apportionment formula *must*, under both the Due Process and Commerce Clauses, *be fair.*" *Container Corp. of America* v. *Franchise Tax Board*, 77 L.Ed 2d, at p. 556. [Emphasis supplied]

There is another recognized yardstick which illustrates the extent of distortion in the present appeal.

In *Moorman Mfg. Co.* v *Bair, supra*, this Court upheld the use by the State of Iowa of a single-factor sales formula to apportion the income of a multistate taxpayer, holding in effect that the taxpayer failed to show that the formula resulted in a misallocation of income. In *Exxon Corporation* v *Wisconsin Department of Revenue, supra*, this Court noted that the portion of the tax base assigned to Wisconsin

by a three-factor formula compared favorably with the taxpayer's sales in Wisconsin. The percentage of *Exxon's* net income apportioned to Wisconsin (22%) was substantially less than the percentage of *Exxon's* total sales (41%) attributed to that state.

In *Exxon,* the "sales only" approach would have apportioned *more,* not less, income to the taxing state. In the case of appellant, a "sales only" approach would have apportioned 31.2% *less* income to California, as shown in Table VII:

TABLE VII

Year	% California Sales to Worldwide Sales	Combined Apportionable Income*	Assignable to California	California Income**	Differential	% Differential
10/31/60	4.5157	$113,528,671	$ 5,126,614	$ 7,247,670	$2,121,056	29.3
61	4.1105	121,514,288	4,994,845	7,043,090	2,048,245	29.1
62	3.7060	118,485,693	4,391,080	6,472,755	2,081,675	32.2
63	3.6404	125,533,580	4,569,924	6,977,784	2,407,860	34.5
4-yr. Avg.	3.9764	$479,062,232	$19,082,463	$27,741,299	$8,658,836	31.2

* Per assessments [Exhibit 382]

** Per assessments [Exhibit 382]

Moreover, a single factor sales formula would have reduced appellant's aggregate tax liability for the period in issue by $648,350, or by almost 42%, hardly an insubstantial amount.

In short, the record clearly demonstrates that significant multiple income tax burdens actually occurred when California superimposed its formulary apportionment method on the incomes of appellant's foreign subsidiaries, whose incomes were fully taxed by the foreign countries in which they did business.

E. Inclusion of the Pre-Tax Income of Ravenna Arsenal, Inc. in Appellant's Apportionable Tax Base, Without a Corresponding Adjustment to Any of the Three Factors of the Formula, Likewise Causes a Major Distortion of Income

The issue of factor relief discussed in connection with Plantations Company is likewise present with respect to one of appellant's domestic United States subsidiaries, Ravenna Arsenal, Inc. ("Ravenna").

During the period in issue Ravenna operated a shell-loading facility for the United States Department of Defense at Ravenna, Ohio [R.T. 814:20 - 28]. Ravenna filed its own federal corporate income tax return (Form 1120) but did not file a franchise tax return with California, since it was not doing business there. Neither the income nor the factors of Ravenna were included by appellant in its own California returns.

Respondent, nevertheless, concluded that Ravenna was part of a unitary business with appellant and added Ravenna's income to appellant's apportionable tax base. The Court of Appeal affirmed the holding of the trial court that no adjustments to any of the factors were required on account of this income. [App. "B", pp. 15-16.]

The determination by the Court of Appeal that no adjustments are required to the factors of the formula on account of inclusion of the income of Ravenna in appellant's apportionable tax base is totally in error, for the same reasons advanced with respect to the Liberian leasehold.

According to the evidence, Ravenna operated an ammunition depot for the United States Government at a defense facility near Kent, Ohio, at which ammunition shells were loaded and stored [R.T. 937:12 - 23; 1285:10 - 15]. The Ravenna Arsenal was sizeable facility [R.T. 1635:14 - 18], having several hundred employees and at least one production line in operation on a regular basis during the period

in issue [R.T. 937:12 - 23]. The contracts which Ravenna had with the federal government were primarily of the cost-plus-fixed-fee type [R.T. 1304:12 - 16], the profits from which (as reflected in its federal taxable income) were included by respondent in appellant's tax base [R.T. 1304:1 - 8].

Unless adjustments are made, there is nothing whatsoever in the formula on account of Ravenna with which to apportion the Ravenna income [R.T. 1306:2-8]. Obviously, a distortion of income results when appellant's tax base is increased by reason of Ravenna's income without corresponding factor relief. If, for example, the Ravenna income were the only income in the apportionable base, such income would be wholly allocated to California, absent an adjustment to the factors of the formula, since there would be no factors with which to apportion the income. Such a result would belie both the economic and jurisdictional realities with respect to Ravenna, which did no business in California and whose entire income was derived outside of the state.

Indeed, this Court recognized in *Container Corp.* v *Franchise Tax Board* that the three-factor formula is based "on the *proportion* of a unitary business's total payroll, property, and sales which are located in the taxing state." 77 L.Ed 2d, at p. 556. Obviously, a "proportion" cannot be achieved without factors by which to accomplish it. Unless therefore the factors are adequately represented, there cannot be any true apportionment and the formula is necessarily distortive.

II.

THE COURT OF APPEAL APPLIED AN INCORRECT STANDARD OF APPELLATE REVIEW IN REVERSING THE DETERMINATION OF THE TRIAL COURT THAT THIRTEEN OF APPELLANT'S FOREIGN SUBSIDIARIES WERE NOT UNITARY

In *Container Corp.* v *Franchise Tax Board, supra,* this Court set forth a standard of appellate review for use in measuring the sufficiency of state court determinations on the unitary business issue. This two-fold test is limited to an examination whether (1) the state court applied the correct standards to the case and (2) its decision was "within the realm of permissible judgment." 77 L.Ed 2d, at p. 560. The Court of Appeal misapplied this standard of review, as will hereafter be shown.

It cannot seriously be argued that the trial court failed to apply the correct legal standards to its determination of the unitary issue. In this respect, the trial court held:

> "Applying the test of *Butler Brothers v. McColgan,* (1941), 17 Cal.2d 664, and *Edison California Stores, Inc. v. McColgan,* (1947) 30 Cal.2d 472, is the proper method of determining whether any activity of the taxpayer or its subsidiaries, whether foreign or domestic, should be included in a unitary business whose income is apportioned to determine the proper measure of the California tax." [C.T. 2010:23-2011:2].

In a related Finding of Fact, the trial court found there was "insufficient inter-dependence, inter-contribution, unity of use and operation to make the [thirteen foreign subsidiaries] a part of [appellant's] unitary business." [C.T. 2008: 19-21].

The case below was tried on a disputed evidentiary record. With the exception of relatively minor peripheral facts pertaining to administrative details, the substantive

facts were in dispute. The state trial court, having weighed the evidence, made the Finding quoted above.

Instead of limiting its review to a determination whether the decision of the state trial court was "within the realm of permissible judgment", it is apparent that the Court of Appeal searched the record for evidentiary indicia which might have supported an opposite determination with respect to the unitary business issue, and in the process ignored or wholly discounted the evidence which tended to support the decision actually made by the lower court.

Obviously, in any unitary business case with an evidentiary record as complex as the present one there are potentially as many factors on one side of the unitary line as on the other. In recognition of this phenomenon, this Court has served notice that an appellate court, in reviewing a unitary business case, should forego re-examination, as though it were a court of first instance, of findings of fact supported by substantial evidence. 77 L.Ed 2d, at p. 560. This Court did not, it must be noted, search the record in the *Container* case for the presence of factors, however many there may have been and whatever weight they may have had, which would have supported a determination opposite to that made by the state trial court. Once this Court found, in its process of appellate review, sufficient facts supportive of the state court judgment, the matter was concluded.

The Court went on to articulate its reasons for applying a more limited standard of appellate review in unitary tax cases, in the following excerpt:

> "The legal principles defining the constitutional limits on the unitary business principle are now well established. The factual records in such cases, even when the parties enter into a stipulation, tend to be long and complex, and the line between 'historical fact' and 'constitutional fact' is often fuzzy at best. [Citation omitted.] It will do the cause of legal certainty little

> good if this Court turns every colorable claim that a state court erred in a particular application of those principles into a de novo adjudication, whose unintended nuances would then spawn further litigation and an avalanche of critical comment. Rather, our task must be to determine whether the state court applied the correct standards to the case; and if it did, whether its judgment 'was within the realm of permissible judgment.' " 77 L.Ed 2d, at p. 560.

Although paying lip service to the principles of *Container*, the Court of Appeal has in effect stood the *Container* standard of review on its head, in reversing the decision of the trial court with respect to the thirteen foreign subsidiaries which were found not to be unitary.

III.

A DECISION BY THIS COURT ON THE CONSTITUTIONAL ISSUES PRESENT IN THIS APPEAL WILL HAVE WIDE IMPACT ON THE TAXING COMMUNITY

Now that worldwide combined reporting has been held to be a valid method for states to tax the incomes of multijurisdictional taxpayers, the focus of inquiry logically is directed to the composition of the apportionment formula. The decision of this Court in the *Container* case defines the contours of the tax base, in the sense that the tax base of a domestic multinational taxpayer engaged in a unitary business may now include the pretax profits of its foreign subsidiaries. The decision, however, is silent as to the factor relief, if any, which must accompany inclusion of income in the tax base and is inconclusive as to the parameters of distortion Constitutionally permissible under the worldwide combination method.

Both of these unanswered issues are present in the instant appeal.

The subject issues are of no small import to the taxing community as well as to taxpayers potentially affected thereby. A recent study by the Task Force commissioned by the President of the United States to examine the unitary business/formulary apportionment issue estimates that forty-five of the fifty states use some method of formulary apportionment to divide the income of a taxpayer operating across state borders; that of these states approximately one-half use the unitary apportionment method to determine their share of the income of multicompany groups operating across state lines through subsidiaries; and that of these latter states approximately one-half use the so-called worldwide unitary method of taxation. cf. "Report to Worldwide Unitary Taxation Working Group", Office of Tax Policy (U.S. Treasury Department, 5/1/84), p.1. Following upon this Court's decision in *Container Corp.* v *Franchise Tax Board*, it is to be expected that the states will expand their usage of the worldwide combined method. Any decision therefore by this Court on the two principal issues presented in this appeal would similarly be expected to have great impact upon the administration of state tax laws, particularly in so far as the composition of income tax apportionment formulas are concerned.

Moreover, the *Container* decision has certainly not undercut the responsibility of this Court to scrutinize the fairness of a particular formulary method in light of the Due Process and Commerce Clauses. After *Container*, it is a question of line-drawing with respect to how much, if any, distortion is Constitutionally permissible in a given factual context. Appellant respectively submits that, wherever this line may fall, it has been crossed in the present appeal, where the record establishes that the California formulary apportionment method as applied to appellant in the context of a worldwide combined report has resulted in a distortion of income which more than quadruples that which was held to be acceptable in the *Container* case.

CONCLUSION

For each of the reasons herein set forth, the Court should note probable jurisdiction of this Appeal.

DATED: July 27, 1984

Respectfully Submitted,

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THE FIRESTONE TIRE &
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IVERSON, YOAKUM, PAPIANO & HATCH

APPENDIX A.

The Firestone Tire & Rubber Company.

List of Majority-Owned Subsidiaries Relevant to This Appeal.

Foreign Subsidiaries

1. FIRESTONE DE LA ARGENTINA S.A.I.C. [Argentina]
2. INDUSTRIA DE PNEUMATICOS FIRESTONE, S.A. [Brazil]
3. FIRESTONE TIRE & RUBBER COMPANY OF CUBA SOCIEDAD ANONIMA [Cuba]
4. FIRESTONE TYRE & RUBBER COMPANY LIMITED [England]
5. FIRESTONE FRANCE S.A. [France]
6. FIRESTONE TYRE AND RUBBER COMPANY OF INDIA, PRIVATE LIMITED [India]
7. COMPANIA HULERA EL CENTENARIO, S.A. [Mexico]
8. FIRESTONE TIRE AND RUBBER COMPANY OF NEW ZEALAND LIMITED [New Zealand]
9. FIRESTONE TIRE & RUBBER COMPANY OF THE PHILIPPINES [Philippines]
10. FIRESTONE PORTUGUESA S.A.R.L. [Portugal]
11. FIRESTONE SOUTH AFRICA (PROPRIETARY) LIMITED [South Africa]
12. FIRESTONE TYRE & RUBBER COMPANY (THAILAND) LIMITED [Thailand]
13. COMPANIA ANONIMA FIRESTONE VENEZOLANA [Venezuela]

14. FIRESTONE TIRE & RUBBER COMPANY OF CANADA, LTD. [Canada]
15. FIRESTONE (CEYLON) LIMITED [Ceylon]
16. FIRESTONE RENGASTUKKU OSAKEYHTIO [Finland]
17. SOCIETE MOROCAINE DE PNEUMATIQUES FIRESTONE [Morocco]
18. FIRESTONE (PAKISTAN) LIMITED [Pakistan]
19. FIRESTONE PLANTATIONS CO. [Liberia]
20. FIRESTONE MALAYA LIMITED [Malaya]
21. THE FIRESTONE TIRE AND RUBBER COMPANY (S.S.) LIMITED [Singapore]
22. UNITED STATES TRADING COMPANY [Liberia]

Domestic Subsidiary

RAVENNA ARSENAL, INC.

APPENDIX B.

Opinion of the Court of Appeal.

In the Court of Appeal of the State of California, Second Appellate District, Division Four.

The Firestone Tire & Rubber Company, Plaintiff, Appellant and Cross-Respondent, v. The Franchise Tax Board of the State of California, Defendant, Respondent and Cross-Appellant. 2 Civ. No. 62918 (Super. Ct. No. 31243).

FILED: January 20, 1984.

APPEAL from a judgment of the Superior Court, Los Angeles County. Norman R. Dowds, Judge. Reversed and remanded.

Iverson, Yoakum, Papiano & Hatch, Neil Papiano and Dennis A. Page for Plaintiff, Appellant and Cross-Respondent.

John K. Van De Kamp, Attorney General, and Neal J. Gobar, Deputy Attorney General, for Defendant, Respondent, and Cross-Appellant.

This is an action for refund of taxes paid by plaintiff (Firestone) to defendant (FTB) for income years November 1, 1960, through October 31, 1963. The court ruled in favor of FTB on all issues, but one. The court ruled that certain foreign manufacturing subsidiaries were not part of Firestone's unitary business.

Firestone appealed from the portion of the judgment which determined that (a) the remaining nine of the foreign companies were engaged in a unitary business with appellant; (b) that worldwide combined reporting is constitutionally permissible; and (c) that worldwide formulary apportionment, as applied to the facts of this case, is nondistortive and properly reflects appellant's California taxable income.

FTB has appealed from the ruling that twelve of the "foreign manufacturing subsidiaries" were not part of Firestone's international unitary business.

The trial court found that "there was sufficient interdependence, inter-contribution, unity of use and operation to make such remaining subsidiaries in issue (i.e., Canada, Ceylon, Finland, Morocco, Pakistan, Liberia, Malaysa, Singapore, United States Trading Company, and United States-Liberia Radio Company) a part of Firestone's unitary business.

The rubber processing subsidiaries that were held to be unitary were Firestone Plantations Company in Liberia, Firestone Malaysa Limited, and Firestone Tire & Rubber in Singapore. These three companies sold large quantities of natural rubber to Firestone. "United States Trading Company" sold consumer goods from the United States at the Liberia Plantation. The four sales subsidiaries held to be unitary sold Firestone branded tires and other goods from Firestone. These were Firestone (Ceylon) Limited, Firestone Ringastukker Osakeyhtio (in Finland), Societe Morocaine de Pneumatique Firestone (Morocco) and Firestone Pakistan Limited.

Firestone appears to have conceded that the Canadian subsidiary is unitary in nature.

The court found that the competent and admissible evidence does not establish any error in the FTB figures used for the property factor with respect to the Liberia plantations, or with respect to the FTB's figures used with respect to Ravenna Arsenal, Inc. The court also found that Firestone has not shown any factual basis for any constitution prohibition against taxation of Firestone's unitary business (including the subsidiaries found to be part thereof) by use of the three factor formula and as otherwise assessed by FTB.

Firestone is engaged in the manufacture, distribution, and sales of tires and other related products in the United States. Appellant also owned a majority and minority of stock in various domestic and foreign companies. These stock certificates were located at Firestone's principal place of business in Akron, Ohio.

Appellant licensed for a fee its processes and technical knowledge to owned and non-owned companies.

Each of the foreign manufacturing companies was located in the foreign countries, was incorporated under the laws of those countries, and had its own board of directors.

During the years at issue a wholly owned subsidiary of appellant, Ravenna Arsenal, Inc., conducted through its employees a shell loading operation for the United States Government at a defense facility at Ravenna, Ohio. Respondent FTB included the taxable income of Ravenna Arsenal in the tax base for the years at issue, it made no adjustment to the property factor on account of government furnished equipment and property at the Ravenna facility, nor did respondent make an adjustment to the payroll factor for salaries, wages and employee benefits paid by the subsidiary to its own employees, nor any adjustment to the sales factor for the gross billing value of the cost-plus-fixed-fee contracts which it had with the federal government.

The trial court found 13 companies not unitary and nine to be unitary.

Respondent, FTB, argues that Firestone Foreign Rubber Procuring & Tire Sales subsidiaries were part of its unitary business, in that it depended on Firestone and its other subsidiaries for suppliers and purchasers and for the benefit of using the Firestone name, for experience and expertise, and for patents and economies of scale.

FTB argues that Firestone failed to establish any distortions requiring modification or rejection of FTB's Formula apportionment. FTB argues that where a business is unitary, as here, Firestone cannot establish distortion by comparing its unadjusted separate accounting records to formula apportionment of income to various parts of unitary business.

FTB also argues that the apportionment of income of unitary international enterprises by formula is constitutional in that the Supreme Court of the United States has approved such formula apportionment. Finally, FTB argues that the trial court's ruling on the assessment procedure and the evidence should be affirmed.

Appellant, Firestone, argues that worldwide combined reporting is unconstitutional and violates the Due Process, Commerce, Supremacy, Separation of Powers and Equal Protection clauses of the State Constitution. Appellant also argues that the adjustments to the formula must be made in order to comply with the statutory mandate that the formula must fairly calculate the amount of income derived by appellant from California sources during the years at issue. Appellant argues that the trial court's finding that nine of its foreign corporations were unitary with appellant should be reversed, that the assessments were arbitrary in character, that the court improperly excluded competent evidence, and that the trial court properly excluded 13 foreign manufacturing companies as not unitary.

I

Appellant first argues that worldwide combined reporting is unconstitutional.

Revenue & Taxation Code section 25101 reads in part as follows:

"When the income of a taxpayer to the tax imposed under this part is derived from or attributable to sources

both within and without the State, the tax shall be measured by the net income derived from or attributable to sources within this State. Such income shall be determined by an allocation upon the basis of sales, purchases, expenses of manufacture, pay roll, value and situs of tangible property or by reference to any of these or other factors or by such other method of allocation as is fairly calculated to determine the net income derived from or attributable to sources within this State; . . ."

Appellant specifically alleges that this section is unconstitutional *as applied* by respondent to the foreign subsidiaries of Firestone.

Appellant argues that while formula apportionment arguably can produce an equitable division of income in a multistate setting, it cannot possibly do so in the context of worldwide combined reporting. Appellant reasons that because of the magnitude of the differential rate of return on investments between the domestic and foreign sectors, the California formula cannot produce an equitable division of income.

We do not agree, for reasons set forth below. Preliminarily, we begin with a brief examination of formula apportionment in California. Formula apportionment is used to determine that portion of the multistate income of a unitary business derived from California sources by artificial use of an arithmetic formula rather than by the "realities of fact and law." (*Fibreboard Paper Products Corp. v. Franchise Tax Board* (1968) 268 Cal.App.2d 363.) As used in California, the formula is comprised of three factors of property, payroll and sales which are located in the taxing state. This particular formula was approved in *Butler Brothers v. McColgan* (1941) 17 Cal.2d 664, and the formula consisting of the factors of property, payroll and sales has often

been sufficient. (*McDonnell Douglas Corp. v. Franchise Tax Bd.* (1968) 69 Cal2d 506.)

Appellant argues that in the context of worldwide combined reporting, the above three factor formula gives no weight or effect to the wide divergence in wage rates, property values, sales prices, confiscating tax laws and expropriation risks which are not present doing business in the United States. Appellant aserts that the lower wage rates and lower property costs abroad causes the three factor formula to produce a distorted result. Appellant also asserts that the increased risk associated with foreign investments also produces a distorted result. Appellant agrees that the apportionment formula, if used in homogeneous areas with similar laws, wage rates and property rates, can accommodate for regional differences, but argues that is not true when used in an international context. Specifically appellant alleges that because there are greater risks associated with foreign investments, these risks, when also considered with lower property costs and wage costs incurred abroad, tend to overstate income derived from domestic sources and understate income earned abroad, where worldwide formulary apportionment is used.

Appellant's figures and charts do support the theory that the formula overstates the profit to California and understates the profit to the foreign country. Thus, appellant has in fact shown that, when applied in the context of worldwide combined reporting, the three-factor formula overlooks the risk factor, varying pay scales, property values and tax laws in the various countries. Appellant concludes from this that the three-factor formula should have no application in international commerce, where the risk factors and rates of profitability associated with doing business abroad have exceeded their equivalents in the United States. However, that is not the law.

The varying risk factor and lower property and wages rates in and of themselves do not preclude the use of the three-factor formula. This court must inquire first whether the tax, notwithstanding apportionment, creates a substantial risk of multiple taxation, and second, whether the tax prevents the federal government from speaking with one voice when regulating commercial relations with foreign governments. If a state tax contravenes either of these precepts, it is unconstitutional under the Commerce Clause. (*Japan Line, Ltd. v. County of Los Angeles* (1979) 441 U.S. 434, 451, 60 L.Ed. 2d 336.) For the tax to be invalid the corporation must demonstrate that there is no rational relationship between the income attributed to the state and the intrastate values of the enterprise so that the income appropriated to the state is out of all proportion to business transacted in the state. (*Container Corporation of America v. Franchise Tax Board* (1983) 77 L.Ed. 2d 545, 563.)

The court in the *Container* case noted that the three-factor formula is necessarily imperfect and that formula apportionment is an imperfect proxy. The court held that the increase in taxable income attributable to California in *Container*, under the three-factor formula was 14%, and that 14% was a far cry from the more than 250% difference which led the court to strike down the state tax in *Hans Rees' Sons, Inc. v. North Carolina Ex.Rel. Maxwell* case (283 U.S. 123, 75 L.Ed. 879, 51 S.Ct. 835 (1931)). The United States Supreme Court in Container stated that the Container Corporation had failed to demonstrate that there is no rational relationship between income distributed to the state and the intrastate values of the business or that the income appropriated to the state is out of all proportion to the business transacted in the state.

While we agree with Firestone that there was some disproportion, Firestone has not shown that the income appropriated to California is out of all proportion to the business transacted in the state. Although the distortion here claimed is greater than in the *Container* case, it is a far cry from the 250% difference found to exist in the *Hans Rees' Sons* case.

Thus, the Supreme Court in the *Container* case clearly held that multi-national formula apportionment is proper.

The Supreme Court in *Container Corporation of America v. Franchise Tax Board* (June 27, 1983), 77 L.Ed 545, noted that the rule has been that where the court determines that a certain set of activities constitutes a unitary business, a state must apply a formula apportioning the income of that business within and without the state. The *Container* court extended that rule to a multi-national setting and held that when a corporation was engaged in a unitary business with foreign subsidiaries, the use of the three-factor formula to apportion income of the unitary business consisting of appellant and its foreign subsidiaries was fair. The *Container* court held that the unitary business principle and formula apportionment method may be used to tax business operating outside of the jurisdiction, and that apportioning the income of a unitary business between the taxing jurisdiction and the rest of the world based on a formula which takes into account objective measures of the corporation's activities within and without the state is proper. The Supreme Court in *Container* specifically held that salient differences among national economies did not render the standard three-factor apportionment formula used by California so inaccurate as applied to the multi-national enterprise consisting of appellant and its foreign subsidi-

aries as to violate the constitutional requirement of fair apportionment.[1] Thus the *Container* case has held that worldwide combined reporting is an appropriate vehicle for taxing unitary business on a worldwide formulary basis, and the three-factor formula used by California is proper, even where the formula is not an exact measure of income earned within the state.

II

Appellant argues that adjustments to the formula are clearly warranted to avoid major distortion of income, should any of appellant's foreign subsidiaries be held to be unitary,[2] and should worldwide combined reporting be held to be constitutional.

Apportionment of income by formula requires a rough approximation (*International Harvester Co. v. Evatt* (1947) 329 U.S. 416, 91 L.Ed. 390), and the taxpayer must sustain the burden of proof to show that the tax was excessive. Formula apportionment cannot be impeached by separate accounting (*Butler Brothers v. McColgan* (1941) 17 Cal.2d 664, aff'd in 315 U.S. 508), but a formulary method that results in assignment of income "out of all appropriate proportion to business activities of a

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[1]Combined reporting is used to define the contours of a unitary business. Combined reporting refers to the identities of separate corporate entities or divisions of a single business enterprise whose incomes are aggregated to arrive at the tax base, whereas formulary apportionment has reference to the method by which the tax base of the combined group, once determined, is apportioned among the various taxing jurisdictions in which the business carries on its activities. (*American Smelting & Refining Co. v. Idaho State Tax Commission*, 99 Ida. 924, 592 P.2d 39 (1979) vacated & remanded 445 U.S. 939, 63 L.Ed. 773, 100 S.Ct. 1333 (1980.)

[2]Since we find the subsidiaries to be part of a unitary business, a matter we shall discuss later, the "adjustment" issue warrants discussion. As we have discussed above, worldwide combined reporting is constitutional.

taxpayer in the taxing state will not be permitted." (*Moorman Manufacturing Co. v. Bair* (1978) 437 U.S. 267, 274.)

Appellant argues that certain adjustments to the formula should be made in that the taxpayer has sustained its burden of showing that an adjustment must be made to avoid distortion. Firestone argues there should be adjustments to the formula on account of (1) variances in prevailing wage scales between the United States and foreign jurisdictions in which appellant's foreign subsidiaries did business, (2) the value of the Liberian leasehold from which the rubber was derived was ultimately sold by appellant's Liberian subsidiary to account for its income, and (3) inclusion of the taxable income of Ravenna Arsenal, Inc., in appellant's tax base. Appellant argues that *McDonnell Douglas Corporation v. Franchise Tax Board* (1969) 69 Cal.2d 506 compels an adjustment to the property factor. Appellant argues that based on *McDonnell Douglas,* only real and tangible personal property owned by the taxpayer was includable in the property factor of the apportionment formula, and leased property should be excluded from the property factor.

The *McDonnell* court stated that the purported rationale for limiting the property factor to properties owned and used by the taxpayer (and for not extending it to property, leased, rented, or furnished cost free by the government) was the "invested capital theory," whereas ownership was considered a measure of investor capital. (*McDonnell Douglas Corporation v. Franchise Tax Board* (1968) 69 Cal.2d at p. 513.) Appellant argues that *McDonnell Douglas* not only invalidates application of the early regulation to government furnished facilities, but to leased property generally.

In the *McDonnell Douglas* case the court noted that although most of the plant used by plaintiff in its opera-

tions, including the plant essential for its fixed-fee contracts, was U.S. Government owned, the tax commission had improperly excluded it from consideration in computing the property factor and the commission had only considered plaintiff's owned property, most of which was in California. The result was an inordinately high ratio to which it attached the same weight as it did to the sales and payroll factors in calculating the net income allocation.

In *McDonnell Douglas* the corporation sustained its burden of proving that the three-factor formula was unreasonable and arbitrary where most of the plant used by plaintiff was government owned, and the commission excluded it from consideration in computing the property factor.

In the *McDonnell Douglas* case, the California Supreme Court neutralized the "invested capital theory and required that an appropriate value on account of plant facilities furnished to the taxpayer on a cost free basis by the government be included in the denomination of the property factor, on the grounds that the use of such plants was essential to the production of income." (69 Cal.2d at 514.) The effect of including their value was to apportion income away from California. The court in the *McDonnell Douglas* case held that an adjustment was required when a formula is intrinsically arbitrary and produces an unreasonable result.

Appellant argues that the Liberian leasehold directly contributed to the generation of the income of the Firestone Plantations Company which was included by respondent in appellant's apportionable tax base, but that the FTB made no adjustment whatsoever to the denominator of property factor on account of the leased rubber producing acreage.

Even assuming that *McDonnell Douglas* not only applies to government furnished facilities, but to leased property generally, a matter we do not here decide, appellant has not supplied the trial court with sufficient evidence to make the adjustment.

Firstly, the trial court rejected Firestone's valuation evidence. Mr. Brandenburg, a former Firestone employee, testified as to the value of the Plantations property, but appellant has not cited us to written records, and appellant has not cited us to evidence that shows that Brandenburg determined the value of the leasehold from books and records. No writing was produced by Firestone showing how it arrived at its estimates, and Brandenburg's writing showed little more than his own work method. The lower court apparently rejected that evidence as insufficient. The validity of Firestone's evidence was a question for the trial court and the court was free to reject the evidence.

Secondly, Firestone's Liberian leasehold interest not cultivated was properly excluded from the denomination of the property factor. First, a witness testified that the only property which is includable in the property factor are properties which are in actual use or available for use in growing rubber trees, and the court was free to accept this evidence.

Thirdly, Firestone alleges that the payroll factor was not correctly computed for nine foreign subsidiaries. Firestone again did not submit sufficient documentary evidence, and Dr. MacDowell's testimony apparently was rejected by the trial court. Also, Firestone did not cite us to evidence concerning the primary methods in various subsidiaries in transferring raw materials, work in progress, or finished products, nor is there a showing that Dr. MacDowell considered the varying amounts of dividends declared by the various foreign subsidiaries and

that reinvestment and declaration of dividend policies have an effect on how much income a company will generate in the future. Thus, the court was free to reject Dr. MacDowell's testimony as having insufficient probative value in regard to FTB's apportionment formula.

Also, we note again, the *Container* court held that the formula need only produce a rough approximation. Although the foreign countries herein had lower wage levels than the United States, they also had lower productivity. The *Container* case has settled that this type of distortion can exist without necessarily invalidating the use of the formula, and for this additional reason no adjustment is necessary.

Appellant argues that an adjustment to the payroll factor is required because of wage differential between California and Liberia during the period in issue. Appellant requests an adjustment to the denomination of the payroll (in the form of an upward revision) to account for the disparity in hourly wage rates which prevailed in Liberia as compared to California. The wage rates in California were 20 times greater than in Liberia. However, no evidence was admitted to the court to show the *actual* wages for each work category, type of work performed, quality of work, or productivity of labor. And again, the *Container* case holds that some distortion can exist without invalidating use of the three-factor formula.

Firestone has failed to prove that adjustments are required for government furnished property at Ravenna. Firestone produced no documents or evidence as to what manner Ravenna was operated, what equipment was used, or the depreciation amount. Although appellant sought to increase the property factor for Ravenna by the "value" of government owned property Firestone failed to furnish insufficient information on how Ravenna was operated, and what part of the property was used.

Firestone relies on *McDonnell Douglas Corporation v. Franchise Tax Board* (1968) 69 Cal.2d 506 for the inclusion of the approximate $254 million property factor. In *McDonnell* the taxpayer was involved in the manufacture of aircraft for the federal government, in plants owned by Douglas. Plaintiff was involved in the manufacture of the plane and taxpayers' own employees were involved in productions. There 100% of the property factor was attributed to California. In the case at bar, Firestone managed Ravenna, and Ravenna's tax returns show absolutely no receipts for sale of tangible personal property. Even if *McDonnell Douglas* applies to the case at bar, which we do not here decide, again Firestone has not supplied us with sufficient documentation to make the adjustment. Thus, while *McDonnell Douglas* may arguably be authority for appellant's allegation as to why there should be an adjustment for the Ravenna subsidiary, we do not decide that matter since appellant has failed to supply the court below with the appropriate figures to make the adjustment.

Firestone seeks to add $5 million to the payroll, but does not cite us to any evidence as to who performed the work or other factors relating to payroll, such as by whom the workers were employed.

Similarly, with respect to the sales factor, there is no record or documentation of sales made by Ravenna to anyone, and Firestone has not cited us to any evidence other than Brandenburg's working papers.

III

Appellant argues that the trial court erred in excluding from evidence the compendii of responses from the foreign companies. The compendii contained evidence with regard to all adjustments which appellant claims must be made to the apportionment formula. If the judgment below (which found the foreign companies to

be unitary) is to be reversed, the compendii would assist in determining the amount of refund.

Mr. Brandenburg had sought to obtain from each of the foreign companies the data to prepare a worldwide combined report, and sent forms to the companies for their response. Appellant sought to have the responses of the companies admitted into evidence under the business records exception to the hearsay rule. (Evid. Code, §1271.) Appellant is correct that it is not always necessary for the specific individual who prepared the business record sought to be admitted to testify. (*Levy-Zentner Co. v. Southern Pacific Transportation Co.* (1977) 74 Cal.App.3d 762, 785.) Secondly, there was sufficient evidence here to show that the compilation took place at or about the time of the event in question, the event being the gathering of recorded information from books and records of the foreign companies. The compendii qualified as a business record exceptional to the hearsay rule.[3]

However, the error was not reversible in view of our finding, to be discussed later, that the businesses were unitary and Firestone is not entitled to a refund.[4]

Since the businesses are unitary and since workload combined reporting is not unconstitutional, the compendii should have been received into evidence from the adjustments which must be made in order to determine appellant's tax base.

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[3]Without unduly lengthening this memorandum, the other factors necessary to find the business record exception to the hearsay rule are present here, and appellant does not dispute this point.

[4]Appellant has not argued that the excluded compendii were relevant on the issue of the adjustment for Ravenna or Liberia Plantation. Appellant suggests that the compendii were relevant in the event that the businesses were held to be not unitary, and that appellant would be entitled to a refund.

IV

Appellant also argues that the assessment is invalid because the auditor allegedly failed to examine individually the relationship of each foreign subsidiary with Firestone and the trial court committed reversible error by limiting examination of the board auditor regarding audit procedures and the manner in which the decision was made that the foreign companies were part of a unitary business with appellant. The auditor was not questioned as to whether facts relating to the 22 foreign companies were examined individually, or what facts the board relied on in making its determination of unit. This evidence was relevant and should have been admitted.

However, there was sufficient evidence to show that the various types of companies in question were part of Firestone's unitary business. There was evidence to show that certain types of subsidiaries were unitary (sales subsidiaries, manufacturing, etc.) and since there is evidence from which to infer similarities in the various types of subsidiaries, this error was not reversible error.

V

Appellant argues that finding nine subsidiaries to be unitary in character was reversible error. The finding of the trial court that nine of the 22 foreign companies were engaged in a unitary business with appellant is supported by the evidence. The United States Supreme Court in the *Container* case recently set up certain standards by which a state court may determine a set of activities constitutes a unitary business. (*Container Corporation of America v. Franchise Tax Board* (1983) 77 L. Ed. 540, 545.) The *Container* court said that where the state appellate court uses the correct legal standard in determining whether appellant is in a unitary business, the decision will be upheld. The Supreme Court will, if

reasonably possible, defer to judgment of state courts in deciding whether or not a particular set of activities constitutes a unitary business.

In the *Container* case the Supreme Court of the United States held the state Court of Appeal had used the correct legal standard. In *Container,* the appellate court said the Container Corporation gave assistance to subsidiaries in obtaining equipment, and in filling personnel needs that could not be met locally. A substantial role was played by appellant in loaning funds to subsidiaries and in guaranteeing loans provided by others, there was an interplay in the area of corporate expansion; technical assistance was provided to subsidiaries, and a supervising role was played by appellant's officers in providing general guidance to the subsidiaries. Therefore, in *Container,* the appellate court's judgment that the subsidiaries were part of a unitary business was within the realm of permissible judgment. The court held that the unitary business principle applies not only to vertically integrated businesses, but to similar enterprises linked by common managerial or operational resources that produced economies of scale and transfer of value.

The *Container* court held that the state may tax income arriving out of interstate activities where there is a minimal connection or nexus between the interstate activities and the taxing state, and there is a rational relationship between the income attributed to the state and the intrastate values. For a state to tax on an apportionment basis a purported unitary business, there must be some showing of exchange of value not capable of precise identification or measurement, beyond the mere flow of funds arising out of a possible investment or a distinct business operation, which renders formula apportionment a reasonable method of taxation. A relevant question in determining whether a particular set of activities constitutes

a unitary business for purposes of taxation is whether contribution to income of subsidiary corporation resulted from functional integration centralization of management, and economies of scale. Thus *Container* found that applying the above principles the subsidiaries were part of the unitary business.

In the case at bar there are a number of factors to support the trial court's judgment that nine of the 22 foreign companies were engaged in a unitary business for the years in question: Firestone's sales subsidiaries engaged in the sale of "Firestone" branded tires which they obtained from Firestone and its subsidiaries. The natural rubber procuring subsidiaries sold rubber to Firestone and its subsidiaries. All of the subsidiaries were part of a basic rubber tire business. All companies used Firestone logo, trademarks, and patents and sold primarily Firestone brand tires. Firestone officials in Akron received reports from subsidiaries. Some management and technical personnel were moved between Firestone and some subsidiaries. Firestone provided loans and guarantees to the subsidiaries.

The above facts provide more than sufficient evidence to support the trial court's holding that the nine subsidiaries in question were part of Firestone's unitary business.

CROSS APPEAL

Cross-appellant, FTB, has cross-appealed on the single question of whether the trial court erred in determining that each of the 12 foreign tire manufacturing subsidiaries were not part of Firestone's unitary business under California law. FTB asserts that this court should hold that Firestone's subsidiaries in Argentina, Brasil, Cuba, England, France, India, Mexico, New Zealand, Phillipines, Portugal, South Africa and Venezuela were part of Firestone's unitary business.

Firestone's own records show that each tire manufacturing subsidiary performed the same basic activities (manufacture and sale of Firestone brand tires) as did Firestone in the United States.

The Firestone name, trademark and logo are used by Firestone and by the Firestone foreign subsidiaries, and their tires bear the Firestone labels. Firestone provided management, technical and auditing services, patents and inventions to the subsidiaries. Firestone required the subsidiaries to meet its standards of quality. Managers and other experts were sometimes transferred to foreign subsidiaries and Americans working at some foreign subsidiaries retained substantial employee benefits from Firestone.

The "Firestone International Company" in the United States approved the subsidiaries major expenditures and budgets. The various subsidiaries were strategically located and supplied certain materials and products to each other and were not in competition with each other. Firestone made substantial loans and guarantees of loans. The new materials were supplied substantially by the subsidiaries. Also, respondent's evidence shows that there was some involvement of Firestone's highest management in operations of foreign subsidiaries.

In *Butler Brothers v. McColgan* (1941) 17 Cal.2d 664 the Supreme Court recognized that the unitary business principle could apply, not only to vertically integrated enterprises, but also to a series of similar enterprises operating in various jurisdictions but linked by common managerial or operational resources that produced economies of scale and transfer of value. We note again that the United States Supreme Court will, if reasonably possible, defer to the judgment of the state court in deciding whether a particular set of activities constitutes a unitary business, and the taxpayer has the burden of establishing

his exemption. The state court must apply the correct standard and the state court's determination must only be within the realm of permissible judgment. (*Container* case, *supra.*) Also, in *Container,* the state court relied on the observation that high officials of appellant gave directions to subsidiaries for compliance with the parent's standard of professionalism, profitability, and ethical practices.

Again we note that the relevant question in the unitary business inquiry was whether contributions of income of subsidiaries resulted from functional integration, centralization of management and economies of scale. Substantial mutual interdependence can arise in a variety of ways and substantial flow of goods is clearly one but just as clearly not the only one way. Potential control is not dispositive, but it is relevant also.

The *Container* court noted that where the parent company plays a management role that is grounded in its own operation expertise and its overall operational strategy, there is an operational role. As we have said before, in the *Container* case, the United States Supreme Court said the state Court of Appeal relied on a large number of factors in reaching its judgment that appellant and its foreign subsidiaries constituted a unitary business. These included appellant's assistance to its subsidiaries in obtaining used and new equipment and filling personnel needs that could not be met locally, loaning funds and guaranteeing loans, and considerable interplay between appellant and its foreign subsidiaries in the area of corporate expansion, the technical assistance provided to the subsidiaries, and the supervisory role played by appellant's officers in providing general guidance to the subsidiaries.

The Supreme Court said they need not decide whether any of these factors would be sufficient as a constitu-

tional matter to prove the existence of a unitary business, but taken in combination, at least, they clearly demonstrate that the state court therein reached a conclusion within the realm of permissible judgment.

We believe the trial court erred in its finding that these manufacturing businesses were not part of Firestone's unitary business, even though most (but not all) of these firms had no directors or officers in common with the parent, and even though these firms had their own pricing systems, tax returns, legal departments and advertising campaigns. We agree with FTB that the facts here establish the unity of Firestone's foreign manufacturing subsidiaries even more strongly then those in the *Container* case, and we hold that Firestone's 13 foreign manufacturing subsidiaries were part of its unitary business.

Here the parent and subsidiaries were engaged in the same activity (manufacturing rubber tires), the parent's technical expertise was available to the subsidiaries under technical service agreements, each company had a separate international department; reports were made in the parent company concerning the operations of foreign subsidiaries; there was some shifting of personnel; Firestone loaned money, equipment, and capital equipment, and sometimes some inventory or raw materials to foreign manufacturing subsidiaries.

Also, there was worldwide use of patents, copyrights, trademarks, mutual benefit of Firestone's advertising, substantial flow of raw rubber to the manufacturing subsidiaries, and a flow of Firestone brand tires to sales subsidiaries. The evidence that these businesses were part of Firestone's unitary business is overwhelming.

This case is distinguishable from *Asarco, Inc. v. Idaho State Tax Commission* (1983) 73 L.Ed. 787. *Asarco* stated that in each case a due process analysis requires a careful examination of the way in which the corporate enterprise

is structured and operates, and its relationship with the taxing state. In *Asarco* the requisite connections were lacking. Applying the rule of *Asarco* to the case at bar, and analyzing the way Firestone operates and its relationship to California, we have the requisite connection.

Similarly, in *F. W. Woolworth Co. v. Taxation & Revenue Dept. of New Mexico,* (1982) 73 L.Ed. 2d 819, the court found a lack of an operational role on the part of the parent. The court in *Woolworth* held there was an absence of centralized management and controlled interaction and that the corporation's operations were not functionally integrated with its subsidiaries. In *Woolworth,* each subsidiary was responsible for its own financing from sources other than the parent, decisions concerning merchandising, site selection, and advertising were made independently, and Woolworth did not rotate or exchange personnel. There is no evidence in *Woolworth* that the subsidiaries purchase, or are required to purchase, from any particular source. These factors in *Woolworth* distinguish that case on its facts from the one before us. In the case at bar, as we have discussed above, there was the requisite connection, which we have discussed in some detail above, that was so clearly lacking in *Woolworth.*

Reversed and remanded for proceedings consistent with this opinion.

NOT TO BE PUBLISHED.

KINGSLEY, Acting P.J.

We concur:

McCLOSKY, J.

AMERIAN, J.

APPENDIX C.

Order Denying Rehearing and Modifying Opinion.

In the Court of Appeal of the State of California, Second Appellate District, Division Four.

The Firestone Tire & Rubber Company, Plaintiff, Appellant and Cross-Respondent, v. The Franchise Tax Board of the State of California, Defendant, Respondent and Cross-Appellant. 2 Civ. No. 62918 (Super. Ct. No. 31243).

FILED: February 9, 1984.

THE COURT:*

I

The petition for rehearing, filed herein on February 3, 1984, is denied.

II

Good cause appearing, the opinion heretofore filed on January 20, 1984, is hereby modified as follows:

(1) The following clerical errors in the Xerox opinion are hereby corrected as follows:

(a) On page 3, in line 20 delete the word "constitution" and substitute the word "constitutional."

(b) On page 19, in lines 4, 8 and 13, delete the name "MacDowell" and substitute the name "McDonald."

(c) On page 20, line 5, delete the word "denomination" and substitute the word "denominator."

(d) On page 24, line 1, delete the word "workload" and substitute the word "worldwide."

On page 24, line 3, delete the word "from" and substitute the word "for."

(e) On page 25, line 5, delete the word "ocurt" and substitute the word "court."

(f) On page 32, line 6, delete the word "then" and substitute the word "than."

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*KINGSLEY, Acting P.J.; McCLOSKY, J.; AMERIAN, J.

(2) On page 15, delete the sentence appearing in lines 10 through 14, commencing with the word "Appellant."

(3) On page 34, delete lines 7 and 8 and substitute the following language:

"The judgment is affirmed on Firestone's appeal; it is reversed on Franchise Tax Board's cross-appeal. The case is remanded to the trial court with directions to enter a new judgment that Firestone take nothing. The Franchise Tax Board shall recover its costs on this appeal."

NOT TO BE PUBLISHED.

APPENDIX D.

Order.

Clerk's Office, Supreme Court, 4250 State Building.

San Francisco, California 94102, May 2, 1984.

I have this day filed Order Hearing Denied.

In re: 2 Civ. No. 62918, The Firestone Tire & Rubber Co. vs. The Franchise Tax Board.

Respectfully,
Clerk

APPENDIX E.

Findings of Fact and Conclusions of Law.

Superior Court of the State of California for the County of Los Angeles.

The Firestone Tire & Rubber Company, an Ohio corporation, Plaintiff, vs. The Franchise Tax Board of the State of California, Defendant. No. C 31243.

FILED: April 22, 1980.

Said action having come on regularly for trial in Department 41 of the above-entitled court, the Honorable Norman R. Dowds, Judge presiding, without a jury, on November 16, 17, 27, 28, 29, and 30 and December 1, 4, 5, 6, 7, 8, 12, 13, 14, 15, 18, 19, and 20, 1978, plaintiff The Firestone Tire and Rubber Company having appeared by Iverson, Yoakum, Papiano & Hatch, Neil Papiano, Esq., Dennis A. Page, Esq., and Frederick V. Geisler, Esq., its attorneys, and defendant Franchise Tax Board having appeared by Evelle J. Younger, Attorney General, and by Neil J. Gobar, Esq. and Charles C. Kobayashi., Deputy Attorneys General, and evidence, both oral and documentary, having been introduced on behalf of both parties and the parties having entered into certain stipulations and the matter having been argued and submitted, the Court, having considered the evidence and stipulations and arguments of counsel, makes the following Findings of Fact and Conclusions of Law:

FINDINGS OF FACT

1. Plaintiff The Firestone Tire & Rubber Company (hereinafter sometimes referred to as "Firestone") is an Ohio corporation with its principal place of business in Akron, Ohio.

2. Defendant The Franchise Tax Board of the State of California (hereinafter sometimes called "FTB") is the agency of the State of California which administers

the bank and corporation tax law of the State of California (hereinafter sometimes called the "California Franchise Tax").

3. Firestone reported its California franchise tax on a fiscal year basis ending October 31 of each year. The period here in issue is November 1, 1989 - October 31, 1963, i.e. income years ending October 31, 1960, 1961, 1962 and 1963. All references herein are to that period unless otherwise indicated.

4. Firestone engaged in business both within and outside the State of California and within and outside the United States.

5. On its California franchise tax returns Firestone reported its own business operations on a combined basis with about 5 wholly owned subsidiaries doing business within the State of California. Thereafter the FTB issued assessments (totaling $574,787.72) on the basis that most of its other domestic subsidiaries and 22 foreign subsidiaries described hereinafter were part of its unitary business. Firestone paid the deficiency asserted and filed claims for refund on the grounds described in paragraph 6 hereinafter among others. Said claims were denied. This suit for refund was filed.

6. The following issues were raised by Firestone at the trial of this action:

a. Did the manner of conduct of the administrative proceedings invalidate the assessments and entitle Firestone to refund;

b. Which of Firestone's foreign (i.e. incorporated outside the United States) subsidiaries, domestic (i.e. incorporated in the United States) subsidiaries, and divisions were improperly included in Firestone's unitary business;

c. To what extent do constitutional or other legal prohibitions prevent inclusion of subsidiaries, particularly foreign subsidiaries, in the unitary business;

d. To what extent do constitutional or other legal provisions require modification of the three factor formula and procedures used by FTB in apportioning unitary income and determining Firestone's California franchise tax;

e. What was Firestone's proper amount of California franchise tax for the years in question and what is the proper amount of refund payable herein?

7. During trial Firestone ceased opposing the contention that it engaged in a unitary business for California franchise tax purposes which included all of its own operations (whether by division, branch or otherwise) and those of all of its domestic subsidiaries included by FTB (except U.S. — Liberia Radio); and FTB conceded that Firestone Tyre & Rubber Company (Thailand) Limited had not commenced doing business and was therefore improperly included in the unitary business.

8. Firestone's foreign subsidiaries remaining in issue here are the following:

1. FIRESTONE DE LA ARGENTINA S.A.I.C. [Argentina]
2. INDUSTRIA DE PNEUMATICOS FIRESTONE, S.A. [Brazil]
3. FIRESTONE TIRE & RUBBER COMPANY OF CUBA SOCIEDAD ANONIMA [Cuba]
4. FIRESTONE TYRE & RUBBER COMPANY LIMITED [England]
5. FIRESTONE FRANCE S.A. [France]

6. FIRESTONE TYRE AND RUBBER COMPANY OF INDIA, PRIVATE LIMITED [India]
7. COMPANIA HULERA EL CENTENARIO, S.A. [Mexico]
8. FIRESTONE TIRE AND RUBBER COMPANY OF NEW ZEALAND LIMITED [New Zealand]
9. FIRESTONE TIRE & RUBBER COMPANY OF THE PHILIPPINES [Philippines]
10. FIRESTONE PORTUGUESA S.A.R.L. [Portugal]
11. FIRESTONE SOUTH AFRICA (PROPRIETARY) LIMITED [South Africa]
12. FIRESTONE TYRE & RUBBER COMPANY (THAILAND) LIMITED [Thailand]
13. COMPANIA ANONIMA FIRESTONE VENEZOLANA [Venezuela]
14. FIRESTONE TIRE & RUBBER COMPANY OF CANADA, LTD. [Canada]
15. FIRESTONE (CEYLON) LIMITED [Ceylon]
16. FIRESTONE RENGASTUKKU OSAKEYHTIO [Finland]
17. SOCIETE MOROCAINE DE PNEUMATIQUES FIRESTONE [Morocco]
18. FIRESTONE (PAKISTAN) LIMITED [Pakistan]
19. FIRESTONE PLANTATIONS CO. [Liberia]
20. FIRESTONE MALAYA LIMITED [Malaya]
21. THE FIRESTONE TIRE AND RUBBER COMPANY (S.S.) LIMITED [Singapore]
22. UNITED STATES TRADING COMPANY [Liberia]

Each was incorporated, had its principal place of business and did business primarily in the country indicated after its name. Subsidiaries 1-14 primarily manufactured and sold tires; subsidiaries 15-18 primarily sold tires; subsidiaries 19-21 procured and sold natural rubber primarily (no. 19 operated its own plantations); and subsidiary 22 sold various products in Liberia. These companies (except number 22) are sometimes hereinafter referred to by country rather than company name.

9. There was insufficient inter-dependence, inter-contribution, unity of use and operation to make the following subsidiaries a part of Firestone's unitary business: Argentina, Brazil, Cuba, England, France, India, Mexico, New Zealand, Philippines, Portugal, South Africa, Thailand and Venezuela (the aforesaid subsidiaries are sometimes referred to as the "foreign manufacturing subsidiaries").

10. There was sufficient inter-dependence, inter-contribution, unity of use and operation to make each remaining subsidiaries in issue (i.e. Canada, Ceylon, Finland, Morocco, Pakistan, Liberia, Malaya, Singapore, United States Trading Company, and United States — Liberia Radio Company) a part of Firestone's unitary business.

11. The facts presented in this case establish nothing illegal or improper in the manner of the assessment or the determination of the factors to be considered in determining the portion of income of the unitary group properly allocable to California, and no impropriety in the amount of the assessment except that the foreign manufacturing subsidiaries should not have been included in the unity in determining Firestone's California franchise tax and the wage factor should be adjusted to reflect actual fringe benefits proved at trial but not made available for the FTB assessment.

12. The competent and admissible evidence before the Court does not establish any error in FTB figures used for the property factor with respect to the Liberia plantations or in regard to the FTB figures used for any of the factors with respect to the Ravenna Arsenal, Inc.

13. Firestone has not shown any factual basis for any constitutional prohibition against taxation of Firestone's unitary business (including the subsidiaries found to be part thereof) by use of the 3 factor formula and as otherwise assessed by FTB.

14. Without waiving any of their respective rights or contentions in the trial Court or on appeal, Firestone and FTB have stipulated that on the basis of the Court's Findings of Fact and Conclusions of Law herein the proper amount of the tax refund herein is $231,739.08, the proper amount of interest refundable as tax is $129,345.50 and the interest on said refund under Revenue and Taxation Code Section 26107 is $274,484.91 to March 10, 1980.

Based upon the foregoing Findings of Fact, the Court makes the following:

CONCLUSIONS OF LAW

1. Neither the Constitution of the United States, treaties between the United States and foreign countries, the Constitution of the State of California, statutes or case decisions (including *Japan Lines Ltd. v. County of Los Angeles* (1979) ___ U.S. ___, 60 Law Ed.2d 336) preclude consideration of the income, property, sales and payroll of the foreign subsidiaries which are part of Firestone's unitary business as part of the income, property, sales and payroll of the unitary business in order to determine what portion of the income of the unitary business is properly apportioned to California (as income

taxable by California to those members of the unitary business taxable by California).

2. There was nothing illegal or improper in the manner the assessment was made or the determination of factors to be considered in determining the portion of income of the corporate group properly allocable to California.

3. Applying the test of *Butler Brothers v. McColgan* (1941) 17 Cal.2d 664 and *Edison California Stores Inc. v. McColgan* (1947) 30 Cal.2d 472 is the proper method of determining whether any activity of a taxpayer or its subsidiaries, whether foreign or domestic, whether such activities should be included in a unitary business whose income is apportioned to determine the proper measure of the California tax. This test was applied herein by this Court in determining that only the activities of plaintiff's foreign subsidiaries incorporated in Argentina, Brazil, Cuba, England, France, India, Mexico, New Zealand, Philippines, Portugal, South Africa, Thailand, and Venezuela should be excluded.

4. By reason of exclusion of the foreign subsidiaries mentioned in the preceding paragraph from the unitary group Firestone is entitled to refund of $361,084.58, plus $274,484.91 interest through March 10, 1980, a total of $635,569.49, together with interest thereafter pursuant to Revenue and Taxation Code Section 26107, and its costs of suit herein.

DATED: April 22, 1980.

/s/ DOWDS
Norman R. Dowds
Judge of the Superior Court

APPENDIX F.

Judgment.

Superior Court of the State of California for the County of Los Angeles.

The Firestone Tire & Rubber Company, an Ohio corporation, Plaintiff vs. The Franchise Tax Board of the State of California, Defendant. No. C 31243.

FILED: April 22, 1980.

This cause came on regularly for trial on November 16, 1978 in Department 41 of the above-entitled Court, the Honorable Norman R. Dowds, Judge presiding, sitting without a jury, a jury having been duly waived. Plaintiff appeared by its attorneys, Iverson, Yoakum, Papiano & Hatch, Neil Papiano, Esq., Dennis A. Page, Esq., and Frederick V. Geisler, Esq. Defendant appeared by its attorneys, Evelle J. Younger, Attorney General, and by Neil J. Gobar, Esq. and Charles C. Kobayashi, Esq., Deputy Attorneys General. Evidence both oral and documentary having been presented by both parties, the cause having been argued and submitted for decision, and the court, on request of both plaintiff and defendant, having caused to be made and filed herein its written Findings of Fact and Conclusions of Law.

IT IS ORDERED, ADJUDGED AND DECREED that plaintiff, The Firestone Tire & Rubber Company, shall recover from defendant, The Franchise Tax Board of the State of California, the sum of Three Hundred Sixty-One Thousand Eighty-Four Dollars and Fifty-Eight Cents ($361,084.58), plus interest through March 10, 1980 in the sum of Two Hundred Seventy-Four Thousand Four Hundred Eighty-Four Dollars and Ninety-One Cents ($274,484.91), together with interest calculated from March 10 to April 22, 1980 on $361,084.58 pursuant to Revenue and Taxation Code §26107, in the

sum of $4,985.52, total of $640,555.01, together with its costs of suit in the sum of $.

DATED: April 22, 1980.

/s/DOWDS
NORMAN R. DOWDS
Judge of the Superior Court

APPENDIX G.

Notice of Appeal.

Superior Court of the State of California for the County of Los Angeles.

The Firestone Tire & Rubber Company, an Ohio corporation, Plaintiff, v. The Franchise Tax Board of the State of California, Defendant. No. C 31243.

FILED: May 23, 1980.

Iverson, Yoakum, Papiano & Hatch, 611 West Sixth Street, Suite 1900, Los Angeles, CA 90017, (213) 687-0711, Attorneys for Plaintiff.

Plaintiff The Firestone Tire & Rubber Company, an Ohio corporation, appeals to the Court of Appeal of the State of California, Second Appellate District, from that portion of the Judgment entered herein on April 22, 1980 in Book 7608, Page 349 to the effect that:

1. The following corporations were engaged in a unitary business with plaintiff during the years at issue:

FIRESTONE TIRE & RUBBER COMPANY OF CANADA, LTD., a Canada corporation

FIRESTONE (CEYLON) LIMITED, a Ceylon corporation

FIRESTONE RENGASTUKKU OSAKEYHTIO, a Finland corporation

SOCIETE MOROCAINE DE PNEUMATIQUES FIRESTONE, a Morocco corporation

FIRESTONE (PAKISTAN) LIMITED, a Pakistan corporation

FIRESTONE PLANTATIONS CO., a Liberia corporation

FIRESTONE MALAYA LIMITED, a Malaya corporation

THE FIRESTONE TIRE AND RUBBER COMPANY (S.S.) LIMITED, a Singapore corporation

UNITED STATES TRADING COMPANY, a Liberia corporation

2. Worldwide combined reporting is not violative of the Due Process, Foreign Commerce, Supremacy, Foreign Policy, or Treaty-Power clauses of the federal constitution.

3. Worldwide formulary apportionment is nondistortive and that no adjustments other than to the payroll factor on account of actual fringe benefits proved at the trial are required to be made in the three-factor formula used by defendant to apportion the combined incomes of plaintiff and such of its majority-owned foreign subsidiary as were included in its combined reports for the years at issue.

4. Neither the Constitution of the United States, treaties between the United States and foreign countries, the Constitution of the State of California, statutes or case decisions (including *Japan Line, Ltd. v. Count of Los Angeles* (1979) ____ U.S. ____, 60 L.Ed.2d 336, 99 S. Ct. ____) preclude consideration of the income, property, sales and payroll of the foreign subsidiaries which are part of Firestone's unitary business as part of the income, property, sales and payroll of the unitary business in order to determine what portion of the income of the unitary business is properly apportioned to California (as income taxable by California to those members of the unitary business taxable by California).

5. There was nothing illegal or improper in the manner in which the assessments were made or with respect to the determination of factors to be con-

sidered in determining the portion of income of the corporate group properly allocable to California.

6. Applying the test of *Butler Brothers v. McColgan* (1941) 17 C.2d 664 and *Edison California Stores Inc. v. McColgan* (1947) 30 C.2d 472 is the proper method of determining whether any activity of a taxpayer or its subsidiaries, whether foreign or domestic, should be included in a unitary business whose income is apportioned to determine the proper measure of the California tax.

DATED: May 23, 1980

IVERSON, YOAKUM, PAPIANO & HATCH

By /s/ DENNIS A. PAGE

Attorneys for The Firestone Tire & Rubber Company, an Ohio Corporation, Plaintiff and Appellant

APPENDIX H.

Notice of Appeal to the Supreme Court of the United States.

In the Court of Appeal of the State of California, Second Appellate District, Division Four.

The Firestone Tire & Rubber Company, Plaintiff, Appellant, and Cross-Respondent vs. Franchise Tax Board, Defendant, Respondent and Cross-Appellant. 2d Civil No. 62918.

Neil Papiano, Dennis A. Page, Iverson, Yoakum, Papiano & Hatch, 611 West Sixth Street, Suite 1900, Los Angeles, California 90017, Telephone: (213) 687-0711. Attorneys for Plaintiff, Appellant, and Cross-Respondent, The Firestone Tire & Rubber Company.

Notice is hereby given that The Firestone Tire & Rubber Company, the Plaintiff, Appellant and Cross-Respondent above-named, hereby appeals to the Supreme Court of the United States from the entire final judgment of the Court of Appeal of the State of California entered in this action on January 20, 1984 (Petition for Rehearing denied by the Court of Appeal on February 9, 1984; Petition for Hearing denied by the Supreme Court of California on May 2, 1984), affirming in part and reversing in part the judgment of the Superior Court of the State of California, in and for the County of Los Angeles.

This appeal is taken pursuant to 28 U.S.C. §1257(2).

Dated: May 8, 1984

Neil Papiano
Dennis A. Page
Iverson, Yoakum, Papiano & Hatch
By /s/ NEIL PAPIANO
Neil Papiano
Counsel for Plaintiff, Appellant
and Cross-Respondent

APPENDIX I.

"*Reg. 25101. Allocation of Income.* (a) Methods of Allocation. Taxpayers who have income from sources within and without the State are taxable only upon the income derived from sources within the State."

"Where the California activities are a part of a unitary business carried on within and without the State, the portion of the unitary income subject to tax in California is generally determined by a three-factor formula of tangible property, payroll and sales. Where the activities carried on within the State are separate from the activities carried on outside this State, the income subject to tax may be determined upon a separate accounting of the California activities."

"Basically, if the operation of a business within the State is dependent on or contributes to the operation of the business outside the State, the entire operation is unitary in character, and the income from California activities will normally be determined by the use of a formula."

. . . .

"*Property Factor.* Tangible property used should be included in the formula at its California tax base. The property factor will normally include the average value of all real and tangible personal property owned by the taxpayer and used in the unitary business. Leased property is excluded from the factor. Also generally excluded is property owned, but not used in the unitary business. Thus, a building is not included in the factor until it is actually used in the unitary business. However, once property has been used in the unitary business, it shall be included in the factor, although temporarily unused for short periods. If the property is permanently withdrawn from unitary use, it should be excluded from the property factor."

. . . .

"*Payroll Factor.* The payroll factor includes all compensation paid to officers and employees such as wages, salaries, commissions and bonuses."

. . . .

"*Sales Factor.* The sales or gross receipts factor generally shall be apportioned in accordance with employee sales activity of the taxpayer within and without the State. This factor is computed on the basis of gross sales or receipts, less returns and allowances."

. . . .

"(e) Subsections (a), (c) and (d) shall apply only to income years beginning before January 1, 1967."

Source: Title 18, *California Administrative Code,* Reg. §25101 (a).